



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201131029**
Release Date: 8/5/2011
Date: May 12, 2011

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL: 513.00-00
514.07-00

Legend:

B =
M =
N =

Dear

We have considered your request dated, December 3, 2007, for a ruling with regard to whether income produced by rental and exempt activities related to your debt-financed property will be included in the computation of your unrelated business income under section 512 of the Internal Revenue Code (Code).

B made a charitable bequest to M, an ecumenical ministry that offers a broad range of social service programs to the poor and distressed or underprivileged. M consists of several territories, including N and you. B made the gift to M to construct community centers in underserved urban areas throughout the country that would attend to spiritual and physical needs, combat juvenile delinquency and provide opportunities for community building. The trust requires M to place one-half of the gift in a capital building fund to purchase real properties and construct, furnish and equip the community centers, and place the other half in a separate endowment fund to be used for employee salaries and other operating expenses. M plans to divide the gift equally between the territories, which will allocate the funds in accordance with the trust provisions.

Before B died, she gave funds to N to build a prototype community center. N found that the portion of the funds allocated to the endowment fund produced only 25 percent of the revenue necessary to cover its operating costs. At this time, N is temporarily redirecting other resources to cover the deficit. You are concerned that, since your allocation of funds will be identical, your reserves would also be insufficient to cover the operating costs of your new centers.

To ensure an adequate level of funding for your new centers' ongoing operations, you plan to finance your centers differently. You would issue construction bonds and use the proceeds to

purchase investment securities that would comprise a reserve fund capable of generating a significant portion of the income necessary to cover operating costs and to serve as a sinking fund for retiring the construction bonds. You agree that the outstanding bond indebtedness is acquisition indebtedness as defined in section 514(c)(1) of the Code.

You have received your part of the gift and identified several communities that you believe would get the most benefit. One center is currently operating and the others are in the planning and construction stages, but you expect them to be substantially similar. You intend to:

- Integrate the spiritual ministry with other services provided by the centers,
- Link the centers' programs to the existing social-service programs that you have established in the communities,
- Provide high-quality personal development opportunities that build character, confidence and competence in young people, families and individuals in an inclusive manner, including opportunities in education, recreation and the arts, and
- Ensure that the centers are accessible to and target a population of children, families and individuals that are underserved.

You selected the communities that showed the most need based on the information collected from the local offices of federal, state and local governments as to population, economic, and demographic statistics. For example, the information you gathered with regard to one community showed that 42 percent of the population lives in poverty (about twice the citywide figure). Residents in this community have twice the citywide rate of public assistance, single-parent families, and households with children under 18.

You base your representations and approximations on the center that is currently operating. All of your centers would offer memberships to the public. You gathered fee information from the health and fitness centers in the communities and set your annual membership fees at less than 20 percent of the fees charged by the other commercial centers in the neighborhoods. Your annual fees would include use of all areas of the centers, except for classes, skating, camps and programs. You would also offer fees on a sliding scale based on government standards for assistance and scholarships to anyone who demonstrates a financial need. If a person is unable to pay, but does not qualify for a scholarship, you have committed to reduce the fee to an amount that the person can pay. You state that you would turn no one away because of inability to pay.

You state that you would devote 85 percent or more of your property to programs that further exempt purposes. For example, you would devote 35 percent of your properties to religious and educational programs. The faith and family center would include a worship area, nursery, food pantry, and dedicated spaces for senior and youth programs. The learning and technology center would offer computer usage, classrooms/seminar rooms, tutoring, technology instruction programs, literacy instruction, GED training, vocation-specific programs and creative arts classes. Finally, the visual/performing arts theater center would offer public performances in music and dance, youth, family and community theater, music lessons, dance programs, visual arts and crafts instruction and exhibition.

You would also use approximately 47 percent of your properties for recreational programs. Your indoor recreational area would offer a fitness center, basketball and sports gymnasium, indoor running/walking track, game room and locker rooms. You would offer a general-purpose swimming pool, leisure pool for children's entertainment, relaxation, fitness and swim instruction and a therapeutic whirlpool for relaxation and rehabilitation. Finally, you would provide an outdoor area for outdoor sports, recreation, and a soccer field, softball/Little League fields, grass volleyball court, general-purpose recreation fields, a skateboarding park, outdoor amphitheater, children's playground, and horticultural center for family and youth development.

Your special programs, which would comprise 15 percent of your facilities, would offer a healthy living center, childcare center, kitchen, library, gathering space, and emergency/disaster services. You would use your kitchen to provide free meals every Monday through Friday to persons who are homeless, unemployed, or otherwise cannot afford a hot meal.

You plan to rent space for various purposes. You would rent space at cost to clubs, community foundations, church groups, schools and other non-profit organizations and individuals that respond to community needs. You estimate that you would rent approximately two percent of floor space and use less than one percent of total open hours for other activities. You would not provide any services in connection to your rental income and you do not anticipate using the facility for any long-term rental activities.

Rulings Requested:

1. Provided that substantially all the use of the centers will be used as described, the rental income, if any, that you derive from the use of the centers will qualify for the exclusion provided by section 514(b)(1)(A).
2. The income that you will receive from the various recreational, charitable, religious, and educational activities conducted at the centers, as described herein, will not constitute income from an unrelated trade or business as defined under section 513(a) because those activities are substantially related to your tax-exempt purposes.

Law:

Section 511 of the Internal Revenue Code (Code) imposes a tax on the unrelated business taxable income (as defined in section 512) of organizations described in sections 401(a) and 501(a).

Section 512(a) of the Code states that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(3) of the Code states that any rents from real property (and incidental related

personal property) are not treated as unrelated business income unless the real property is debt-financed under section 514.

Section 513(a)(2) of the Code states, in pertinent part, that the term “unrelated trade or business” means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, except that such term does not include any trade or business which is carried on by the organization primarily for the convenience of its members, students, patients, officers, or employees.

Section 513(c) of the Code states that the term “unrelated trade or business” includes any activity that is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors, which may, or may not be related to the exempt purposes of the organization.

Section 514(a)(1) of the Code states that there shall be included with respect to each debt-financed property as an item of gross income derived from unrelated trade or business an amount which is the same percentage of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness for the taxable year with respect to the property is of (B) the average amount of the adjusted basis of such property during the period it is held by the organization during such taxable year.

Section 514(b)(1)(A)(i) of the Code states that the term “debt-financed property” means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year except that such term does not include any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501.

Section 514(c)(1) of the Code states that the term “acquisition indebtedness” means, with respect to any debt-financed property, the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property, the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement, and the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Section 1.501(c)(3)-1(d)(2) of the Treasury Regulations (regulations) states that the term “charitable” is used in section 501(c)(3) in its generally accepted legal sense and is, therefore not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-

exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes, in part, relief of the poor and distressed or of the underprivileged, advancement of religion, advancement of education or science, and the promotion of social welfare by organizations designed to accomplish any of the above purposes, or to lessen neighborhood tensions, or combat community deterioration and juvenile delinquency.

Section 1.513-1(d)(1) of the regulations states that gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question – the activities, that is, of producing or distributing the goods or performing the services involved – and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Section 1.513-1(d)(3) of the regulations states that, in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services, which contribute importantly to the accomplishment of any exempt purpose of the organization.

Section 1.513-1(d)(4)(i) of the regulations states that gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business.

Section 1.513-1(d)(4)(i), Example (1) of the regulations described an organization that operated a school to train children in the performing arts. The organization derived gross income from admission charges for the performances. The student's participation in performances before

audiences was an important part of their training. Since the income realized from the performances derived from activities, which contributed importantly to the accomplishment of the organization's purposes, it did not constitute gross income from unrelated trade or business.

Section 1.513-1(d)(4)(iii) of the regulations states that a facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions does not by itself make the income from the commercial endeavor gross income from unrelated trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes.

Section 1.514(b)-1(b)(1)(i) of the regulations states that to the extent that the use of any property is substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or the performance by an organization of its charitable, educational or other purpose or function constituting its basis for exemption under section 501, such property shall not be treated as "debt-financed property". See section 1.513-1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

Section 1.514(b)-1(b)(1)(ii) of the regulations states that if substantially all of any property is used in a manner described in subdivision (i) of this subparagraph, such property shall not be treated as "debt-financed property". In general, the preceding sentence shall apply if 85 percent or more of the use of such property is devoted to the organization's exempt purpose. The extent to which property is used for an exempt purpose shall be determined on the basis of all the facts and circumstances. These may include (where appropriate)—

- a. A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,
- b. A comparison of the portion of such property that is used for exempt purposes with the portion of the property that is used for all purposes, or
- c. Both the comparisons described in (a) and (b) of this subdivision.

Rev. Rul. 59-310, 1959-2 C.B. 146, holds that a nonprofit corporation organized for the purpose of establishing, maintaining and operating a public swimming pool, playground and other recreational facilities for the children and other residents of a community is exempt from federal income tax under section 501(c)(3) of the Code. The organization in question operated in a community consisting principally of low-income groups who are unable to pay the cost of privately sponsored recreation facilities. The income derived from charges for admission to the pool was minor in amount.

Rev. Rul. 79-360, 1979-2 C.B. 236, held that the operation of a health club by an exempt organization constituted an unrelated trade or business within the meaning of section 513 of the Code. It found that the operation of the health club was separate from and in addition to the organization's general physical fitness program, and, also, that the commercially comparable annual dues or fees charged for the health club memberships and for use of the health club

facilities were sufficiently high to restrict use of health club facilities to a limited number of members of the community.

In Isabel Peters v. Commissioner, (1953) 21 T.C. 55, the Tax Court held that providing convenient swimming and recreation facilities for all persons residing in the particular school district and especially those who could not afford to acquire and maintain such facilities was "charitable" as defined under section 501(c)(3) since it promoted the social welfare of the community.

Analysis:

You requested rulings with regard to whether activities associated with the community centers that you plan to acquire with construction bond proceeds will produce unrelated business taxable income (UBIT) as defined in section 512(a) of the Internal Revenue Code (Code). Generally, income produced by debt-financed property is treated as UBIT unless substantially all of its use is substantially related to exempt purposes. The information that you provided, including the careful placement and promotion of your new facilities, types of facilities, services and programs offered, and the manner in which you plan to operate, clearly show that your community centers would further your exempt purposes and benefit a significant segment of the communities. Since substantially all of the use of your property is substantially related to your exempt purposes, your community centers will not be treated as "debt-financed property" within the meaning of section 514(a)(1).

You state that you are exempt from federal tax because you further a religious purpose. Section 1.501(c)(3)-1(d)(2) of the regulations states that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. It is therefore not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes, which may fall within the broad outlines of "charity" as developed by judicial decisions. In the general law of charity, the promotion of the happiness and enjoyment of the members of the community is also a charitable purpose:

"Some of these trusts can be supported on the ground that they tend to promote the health of the community, or involve a form of education; but it is sufficient that they promote the general happiness of the community."

Restatement (Second) of Trusts, section 374 (1959); IV A. Scott, The Law of Trusts section 374.10 (3d ed. 1967).

The principles set forth in section 1.513-1 of the regulations apply in determining whether the operation of your community centers has a substantial relationship to your exempt purpose. See section 1.514(b)-1(b)(i) of the regulations. In the statutory sense, the relationship must be a causal and a substantial one. In other words, to be substantially related to an exempt purpose, the activities conducted by your community centers must contribute importantly to the achievement of your exempt purposes. Section 1.513-1(d)(2) of the regulations. By placing your new centers in communities where more households operate at or below the poverty level

and have children under the age of 18, you would provide relief to the poor or the underprivileged and combat community deterioration. You have taken steps to make sure that all income levels within the community would be aware of and make use of the programs you would offer. You would make centers even more accessible by linking the programs to the existing social-service programs that you have already established in the communities. Many of the programs that you plan to offer, including the faith and family, learning and technology, and visual/theater art as well as disaster relief and library services, would contribute importantly to the accomplishment of your educational, religious, and other charitable purposes.

The term "unrelated trade or business" essentially means any trade or business that is not substantially related (aside from the need of the organization for income or funds) to an organization's exempt purpose. Generally, income from the performance of exempt functions does not constitute gross income from the conduct of an unrelated trade or business. See section 1.513-1(d)(4)(i), Example 1, of the regulations. A facility that is necessary to the conduct of exempt functions may be employed in a commercial endeavor if the activities that produce the income in question contribute importantly to the accomplishment of exempt purposes. See section 1.513-1(d)(4)(iii) of the regulations. For example, you would devote 35 percent of your facilities to religious and educational programs and 15 percent to special programs, both of which contribute importantly to the accomplishment of your exempt purposes. Therefore, any income produced by most of the activities you conduct within these programs would not be UBIT. However, income from one particular activity may be deemed unrelated even where the activity is an integral part of a larger activity that is in furtherance of an exempt purpose. Sections 513(c) of the Code and 1.513-1(d)(3) of the regulations. Therefore, it is necessary to examine more closely the types of activities you would conduct in your centers to determine whether they contribute substantially to the accomplishment of your exempt purposes.

You plan to use 47 percent of your facilities to offer general, aquatic and outdoor recreation programs to your members. Business income generated by recreational facilities can be exempt from unrelated taxable business income under section 511 if the facilities benefit a significant segment of the population. See Rev. Rul. 79-360, *supra*. An exempt organization can demonstrate that it provides a significant benefit by setting its membership fees so that they are affordable to a broad segment of the community. You plan to place your centers in areas that are underserved. For example, you would place one center in an area where 42 percent of the population lives in poverty. Further, you plan to charge fees that local residents can afford. You would charge annual fees at rates that are less than 20 percent of the fees charged by other local commercial centers. You state that your centers would turn no one away because of inability to pay. Your annual fees include use of all areas of the center, except for classes, skating, camps and programs. You would offer fees on a sliding scale based on government standards for assistance and scholarships to anyone who demonstrates financial need. If a person is unable to pay, but does not qualify for a scholarship, you have committed to reduce the fee to an amount that the person can pay. As the Tax Court determined in Isabel Peters, *supra*, and as the Service recognized in Rev. Rul. 59-310, *supra*, providing recreational facilities can be charitable, provided the facilities are available to the general community. Since you would encourage the public to participate in general, aquatic and outdoor recreation at your

centers and you would set affordable fees and turn no one away because of an inability to pay, your centers would benefit a significant segment of the community and the membership fees generated by your centers would not be UBIT.

You plan to rent space in your centers. Generally, section 512 of the Code excludes rental income from the definition of unrelated business taxable income. However, if the rent-producing property is "debt financed", the rental income may be included as an item of gross income from an unrelated trade or business unless the rental activity is substantially related to your exempt purpose. You state that your centers would be "debt-financed" within the meaning of section 514(b)(1)(A) of the regulations. However, the regulations exclude property from the term "debt-financed" if 85 percent or more of the use of such property is devoted to the organization's exempt purpose. Section 1.514(b)-1(b)(1)(ii) of the regulations. The extent to which you use your property for a particular purpose is a determination that is based on all the facts and circumstances. That determination may include a comparison of the portion of the time that you use the property for exempt purposes with the total time you use such property, a comparison of the portion of the property that you use for exempt purposes with the portion of the property that you use for all purposes, or both.

You stated that you would devote 85 percent or more of your property to activities that further religious, charitable and educational purposes. You supported that statement with estimates of the portion of your total property that you would use for each activity that furthers your exempt purposes, which totals more than 85 percent. Your religious and educational programs (35 percent), recreational programs (47 percent), and special programs (15 percent) all further your exempt purposes by enhancing your social services and improving the overall positive impact your centers will have on the community. The remaining 3 percent of your property that you use for other purposes would not produce UBIT because the 85 percent rule prevails. Accordingly, your property is not debt-financed because substantially all of your community center activities would be substantially related to your exempt purposes under sections 513 and 514(b)(1)(A) of the Code and section 1.513-1(d)(2) of the regulations and the income generated by those activities, including income from short-term rentals, would be exempt from unrelated taxable business income.

Summary

Your property is excluded from the definition of "debt-financed" property because substantially all of its use would be substantially related to the exercise or performance of the exempt purposes that constitute the basis of your exemption. This conclusion is supported by your representation that you would devote 85 percent or more of your properties to activities that further exempt purposes, supplemented by detailed descriptions of the use of your property. The rental income from the use of your facilities will be minimal, certainly less than 15 percent, and thus, qualifies for the exclusion from the definition of "debt-financed property" provided by section 514(b)(1)(A) and explained in section 1.514(b)-1(b)(1)(ii) of the regulations. Further, provided that your activities continue to contribute importantly to your exempt purpose, your membership fees and the revenue that you generate from the operation of your other facilities is not unrelated business taxable income.

Based on the foregoing, we rule, as requested, as follows:

1. Provided that substantially all the use of the centers will be used as described, the rental income, if any, that you derive from the use of the centers will qualify for the exclusion provided by section 514(b)(1)(A).
2. The income that you will receive from the various recreational, charitable, religious, and educational activities conducted at the centers, as described herein, will not constitute income from an unrelated trade or business as defined under section 513(a) because those activities are substantially related to your tax-exempt purposes.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ron Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437